PRICEWATERHOUSECOOPERS

Economic Impact Analysis of the Proposed Conversion of Premera Blue Cross for the State of Washington

Report Addendum

CONFIDENTIAL INFORMATION

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February 27, 2004

Prepared for the Washington Office of the Insurance Commissioner

OVERVIEW

This report addendum is prepared as an update to our report dated October 27, 2003 titled "Economic Impact Analysis of the Proposed Conversion of Premera Blue Cross for the State of Washington." Following completion of that report and the reports of other experts engaged by the State of Washington, Premera Blue Cross sought and received approval to amend its Form A application to the Washington Office of the Insurance Commissioner to convert from a non-profit health services contractor to a for profit publicly traded health insurer,[1] originally filed September 17, 2002. The revised Form A was filed on February 5, 2004. The revisions to the Form A were made to address a number of key concerns raised by PricewaterhouseCoopers and others in the reports filed on October 27, 2003. The modifications were discussed in a series of meetings; while many of the specific suggestions of the consulting team are reflected in the revised Form A and accompanying documents, a number of recommendations were not adopted by Premera.

In this addendum we describe the substantive areas of concern identified in our October 27, 2003 report and any changes in the Form A that have been made to address those concerns. We also provide an update to key information that we believe is material to consideration of the conversion application. As with our previous report, these comments relate specifically to our assessment of the potential market impact of the proposed conversion of Premera Blue Cross on the Washington health care market. A separate report is being prepared by another firm that considers the effect of the proposed conversion on the Alaska health care market.[2] Further, numerous other report addendum by PwC and other consultants address other aspects of the review of the proposed conversion.

Issues Identified in October 27, 2003 Report

In the conclusions to our earlier report we raised several substantive issues for consideration in the conversion request including the following:

> *"Our review of Premera's operations highlighted several concerns. Among them are a business plan that does not achieve the target operating margins that are likely to be demanded by the financial markets, enrollment growth assumptions that may be aggressive given the current state economy, an expense allocation methodology that is inconsistent with pricing guidelines and may distort expected operating results by product and line of business,*

[1] Form A: Statement Regarding the Acquisition of Control of a Domestic Health Carrier and a Domestic Insurer. Direct or Indirect Affiliates of Premera by New Premera Corp. September 17, 2002. This was also filed with the Alaska Division of Insurance and the Oregon Insurance Division. http://www.insurance.wa.gov/special/premera/filing.asp

[2] Navigant Consulting, "The Economic and Market Impact on Alaska of the Proposed Conversion of Premera Blue Cross to a For-Profit Entity." September 2003 Draft.

> *and evidence of market power that could be used to raise premiums faster than market trend for members in select geographies and lines of business.*
>
> *Offsetting these negative considerations are positive outcomes that may derive from the Foundation that would be created under Premera's plan of conversion. Should Premera's stock attain maximum value, a substantive Foundation in the State of Washington would be created. The precise role of the Foundation has not been determined, and consequently the impact of the new funds is not known."*[3]

Among our most substantive conclusions was that Premera would have the market power and incentive to directly affect premium rates and product design in much of Eastern Washington in a manner that would increase premiums or reduce access to care for subscribers in that region. We also raised concern regarding Premera's ability to simultaneously protect consumers from adverse consequences and maximize the value of the stock available to the Foundation. Finally, we expressed concern regarding business processes, including expense allocation, that appear to result in cross-subsidization of certain product lines, and in particular, those product lines that are material to Premera's growth goals.

Review of Revised Form A

Premera Blue Cross has prepared a revised Form A application that varies in a number of ways from its original filing. Several components of the revised filing are material to the assessment of the economic impact for the State of Washington of the proposed conversion.

- Premera has made assurances regarding the methods that will be used to develop premium rates in the Individual and regulated Small Group markets;
- Premera has made assurances regarding availability of providers;
- Premera has agreed to certain monitoring processes to ensure compliance with these assurances;
- The structure of the proposed Foundation has been changed to provide for two separate Foundations, with one operated independently in Washington and a second Foundation operated independently in Alaska; and
- Premera has offered a "bring down" certificate as part of the Plan of Conversion that will document whether any material change has occurred in the market circumstances reviewed between October 1, 2003 and the date of the conversion.

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[3] PricewaterhouseCoopers, "Economic Impact Analysis of the Proposed Conversion of Premera Blue Cross for the State of Washington." October 27, 2003. P. 112.

In addition to the documents included in the revised Form A, more recent financial results have become available. Specifically, Premera prepares monthly operating results for management purposes. While we have not had the opportunity to thoroughly assess all of the material in those reports, we have reviewed them for general information on trends and operating performance.

Our Approach

PwC reviewed the revised Form A in light of concerns expressed in our October report and the exchange of information that took place in the intervening time. We also reviewed Premera's more recent financial results to assess performance during 2003 and projected performance in the future. Other components of our original analysis, including review of the economic characteristics of Washington's healthcare market, other key economic characteristics of the State, current and future benefit designs and contracting strategies of Premera and other health insurers, were left unchanged.

Status of Key Issues

In our October report we identified several key issues we believe warrant consideration by the Commissioner regarding the proposed conversion. Each issue is described in the following section. Additionally, we discuss changes made by Premera in its revised Form A and our current assessment of the issue.

Growth Potential

- Our October report noted that Washington has higher average per capita income and higher rates of health insurance coverage than the national average. It also has a higher unemployment rate and population growth has slowed. The population of the state is concentrated in the western urban counties while the eastern counties are predominantly rural and more sparsely populated. The distribution of health care resources has a similar pattern. These characteristics imply that the market for health insurance will not significantly expand in the near future. New health plan enrollment growth is more likely to come from winning business from competitors, possible acquisitions, or development of new markets outside the State of Washington.

- Premera's most recent financial results show somewhat slower than expected enrollment and revenue growth.

Pricing Structure Adequacy

- Our October report raised a number of concerns about pricing structure adequacy. In particular, we discussed issues related to allocation of expenses to business units and ability to achieve target operating results in specific lines of business. Premera states that it operates its business as a "portfolio" and while it has a goal of meeting target margins in each line of business, its primary goal is to meet targets in the aggregate. Specifically, Premera prices its products with a target[ ] Premera faces a number of challenges in meeting targets in certain Washington product lines related to expense allocation, including regulated products, ASC business and new products, including the Dimensions portfolio. It will be critical that Premera be able to accurately measure the cost of all Washington-based stand-alone business units,[4] as well as those in other states, to avoid unintended cross-subsidization. No new information has been provided regarding expense allocation that changes our view on this issue.

Projection Assumptions

- In our October 2003 report we expressed concerns regarding Premera's ability to meet target operating margins. The most recent results show improvements in both the rate of expense growth and in operating income. These future projection assumptions rely on meeting significant improvement goals related to administrative expenses. In discussions with Premera management we learned that the most recent estimates of growth in administrative costs will require substantive changes from current operational practices. Consequently, it will be critical that Premera is successful in implementing those changes in operations to be able to meet its net income goals.

Prospective Rate Increases

- Our October report expressed significant concern about likely premium rate changes, with the expectation that those increases would be largely focused on the products and geographies where Premera has substantive market share. In particular, we identified the Individual and regulated Small Group markets in portions of Eastern Washington as susceptible to material rate increases.

  Premera has offered assurances regarding the methods by which premium rates for these products will be determined following the conversion. Specifically, for a two year period, Premera has agreed to continue using the rate development methods currently in place for those products. While we believe these assurances reduce the likelihood that Premera will increase premium rates in excess of medical trend within the two year period following the conversion, we believe the assurances should be provided for a longer time period to provide greater protection to consumers in Eastern Washington. Specifically, we recommend the assurances be extended to three years or longer. This length of time will allow for two complete rate cycles for small group rates and will help to ensure that consumers are protected during this time period. While we understand that business practices and circumstances in the health insurance market may change materially over time, we do not believe that Premera would be placed at a competitive disadvantage by agreeing to a longer term of the agreement, particularly given Premera's statement that they do not intend to change their rating methodology and in fact do not believe more discrete rate setting would be allowed under Washington regulations.

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[4] Stand-alone business units are generally defined by Premera to be an MBS, but they are in reality further defined by regulation according to product-type, regulatory oversight and corporate governance.

- We noted that if Premera does not retain the preferential Federal tax treatment for Blue Cross and Blue Shield plans, the effective corporate tax rate would increase from 20% to at least 35%. No additional information has been offered that changes this result.

Proprietary Material Redacted

Product Mix and Profitability

- Enrollment projections indicate that the majority of total expected net enrollment growth from 2002 to 2007 is expected to come from [ ] A substantial share of this enrollment growth is expected to derive from ASC business. The current allocation of costs to ASC contracts suggests some subsidization of this product line, with pricing based in large part on marginal costs plus some small portion of fixed costs. If average pricing were used, ASC rates could increase by as much as 28%. A change in pricing of this magnitude would likely inhibit Premera's ability to grow enrollment in this product line to projected levels. Consequently, Premera may be required to continue to subsidize its ASC business. Average rather than marginal pricing for the ASC product line may inhibit Premera's ability to meet its growth and net income goals.

Provider Contracting and Payment Levels

- In our October report we noted that Premera has one of the largest PPO provider networks in the state of Washington. The Foundation network for the Dimensions product reduces contracted network size, but maintains contracts with 79% of the current PPO providers and 92% of the hospitals. The Heritage Dimensions network is a provider network that is comparable to the current PPO network. The premium rate assurances discussed above raise the possibility that Premera will seek to attain higher profit levels in areas where it has significant market power through reductions in payments to providers. To the extent that action is taken, consumers may be harmed if Premera does not maintain a sufficient provider network.

  Premera has included in its assurances an agreement to maintain a statewide PPO product that meets or exceeds the network adequacy standards currently in place for its Heritage network, and to report to the OIC on a quarterly basis any consumer complaints regarding network adequacy. Premera has filed similar network adequacy standards for the other Dimensions networks and we interpret the assurance to also apply to those networks. While we believe these assurances reduce the likelihood that Premera will reduce its network size as a consequence of difficulty in contracting with providers within the two year period following the conversion, we believe the assurances should be provided for a longer time period to provide greater protection to consumers in Eastern Washington. Specifically, we recommend the assurances be extended to three years or longer. Similar to the assurances related to premium rates, we believe this longer time period is essential to protect consumers during at least two complete rate cycles for small group rates. The assurances related to premium rates and network adequacy are linked, and the duration of both assurances must be identical.

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Conclusions

Proprietary Material Redacted

Premera has shown operating gains in recent years, and has presented a planning estimate that anticipates operating margins of approximately . Premera's performance to date and future projections, although weaker than those of comparable companies, show reasonable growth rates in key industry metrics over the five-year horizon studied. Premera is untested as a public company and a continuance of the improvements in recent years will be necessary to enhance Premera's stock value to maximize value to the Foundation. Premera's operating costs are above the average for its peer group, and the Dimensions product is expected to reduce those levels. These administrative cost improvements are built into Premera's projections. To protect consumers and simultaneously provide maximum value to the Foundation, Premera will need to improve its operations while showing growth in net revenues and enrollment, and while improving its net operating margin.

Premera dominates the insurance market in Eastern Washington, with some limited exceptions. Its Dimensions product design may allow it to take greater opportunity of its market power in that area, particularly in the individual and small group markets. Premera is one of several carriers operating in Western Washington and is restricted in its ability to increase premiums in those areas. Premera has offered assurances that it will not change its methods for developing premium rates so as to adversely affect the cost of health insurance for Individuals and Small Groups in Eastern Washington. While the assurances mitigate our concern regarding extraordinary premium rate increases, we believe these assurances must be extended to three years or longer to provide an appropriate level of protection. We also note that the OIC will need to exercise strong oversight to ensure compliance with the pricing aspects of the assurances.

Premera's market dominance affects its relations with providers, with Eastern Washington providers receiving generally lower payment amounts and reporting a greater level of unhappiness with Premera than those in Western Washington. Providers in much of Eastern Washington have limited choice regarding participating in Premera networks. These circumstances will be unchanged following a conversion, while pressure to meet financial performance goals will be heightened, putting added pressure on provider relations. From a consumer perspective, provider relations and contracting are material to the availability of providers in a network for which an insurance premium has been paid. Premera has offered assurances that it will maintain a statewide PPO that meets or exceeds network adequacy standards currently in place for its Heritage product to ensure an adequate provider network and protect consumers. We believe these assurances must be interpreted to apply to other Dimensions networks and be extended to three years or longer to provide a greater level of protection. We also note that the OIC will need to exercise strong oversight to ensure compliance with network adequacy aspects of the assurances.

To the extent that Premera acquires additional capital, it may provide Premera the opportunity to expand into new areas and/or to improve administrative cost efficiencies. Given current market share, Premera's growth opportunities are limited to winning business from competitors or growth of new markets. Consequently, the capital may be used in large part to allow Premera to grow outside of the State of Washington. From the perspective of Washington consumers, this growth may be positive if Premera can gain economies of scale from entering additional markets. Conversely, this expansion into new markets may result in a negative impact on Washington consumers if current Premera members are asked to contribute to the cost of the expansion but are unable to benefit from reduced administrative costs.

Premera's expense allocation formulas appear to result in subsidization of some business lines. As a public company Premera would be expected to report on improvements in operating margins over time in each business line independently. Among the ASC business line in particular, where Premera has targeted significant growth, the current expense allocation model suggests that administrative charges would have to increase significantly to reach target margins without subsidization from other product lines. Premera reports that, to date, marginal pricing for the ASC line has been advantageous, since the revenue attained from the business helps cover at least some portion of fixed administrative costs. As ASC becomes a larger share of Premera's book of business, it will become increasingly important that that product's revenue cover its average cost. Consequently, Premera's growth in this area may be hampered.

Premera has offered a "bring-down" certificate as part of its Plan of Conversion to confirm to the Commissioner at the time of the conversion that there have been no material changes in operations since the time of the hearing. We believe that certification must report any material changes in enrollment separately for Eastern and Western Washington and for the Individual and Small Group product lines. For Washington's purposes, changes in enrollment in Alaska are not directly relevant. Consequently, such changes should be reported separately so that an accurate view of changes in Washington is available. In its revised Form A Premera states that it will report a change:

> *"with respect to the combined operations of PREMERA in Alaska and Washington, any decrease in enrollment of more than ten percent (10%) by any insured line of business (individual, small group, large group or FEP, but excluding Healthy Options/BHP) or decrease in total enrollment of more than five percent (5%) compared to actual enrollment, such change as determined by the annual statutory statements filed by health plans with the Washington Insurance Commissioner or the Alaska Division of Insurance."*[5]

Because our concerns regarding Premera's operations are focused on particular geographic areas and product lines, we do not believe this bring down information will adequately protect consumers. We also believe the change should be reported at lower threshold levels. Specifically, we believe a change of 5% in any particular business line or 3% overall should be reported.

[5] Plan of Conversion of Premera, February 5, 2004. PP 12,

Recommendations

We believe the following changes in the Form A filing would improve the Commissioner's ability to ensure that consumers in Washington are not harmed should Premera Blue Cross' proposed conversion to a for-profit entity be approved:

1. The Washington Economic Impact Assurances in Exhibit E-8 should be in place for a minimum period of three years;

2. Premera should clarify that the network adequacy standards covered in the Assurances apply to all product networks; and

3. The Bring Down Certificate in the Plan of Conversion should be revised to report material changes in enrollment by defined geographic regions, and in particular should report on changes in enrollment separately for the areas of Eastern Washington identified as at-risk in our October 2003 report. The threshold level of change for reporting purposes should be narrowed to 5% in any particular business line or 3% overall. The Commissioner should consider this additional information in the final conversion transaction.

Beyond these recommendations, we believe it remains appropriate to consider whether Premera can simultaneously meet its obligation to protect consumers and provide maximum value to the Foundation through improvements in its operations that result in growth in net revenues and enrollment, and improvements in its net operating margin.